NATURE OF THE GLOBAL ECONOMY AND GLOBALISATION

THE GLOBAL ECONOMY

The global economy is the combined economic activity that takes place in each individual economy, plus the activity between countries. It includes all production, trade, financial flows, investment, technology, labour and economic behaviour in nations and between nations.

The size of the global economy is measured by Gross World Product (GWP).

Economists try to predict trends in the world economy by applying models that demonstrate how changes in certain economic variables or factors have affected the domestic or global economy previously. In the early part of this millennium the state of the domestic and global economies has been largely influenced by non-economic factors – factors that economists would have unlikely predicted. These include the terrorist attacks of September 11, 2001 and subsequent terrorist attacks, the outbreak and spread of the Severe Acute Respiratory Syndrome (SARS) virus, the bird flu and more recently conflicts in the middle-East (including the Arab Spring uprisings in Syria and Egypt). These factors have had a great influence on the state of the global economy in recent years, and these, and similar events, will continue to do so into the future. In early 2011 the Tsunami on the East Coast of Japan caused widespread devastation and the human and economic costs are still being felt many years later. Further to this, earthquakes, cyclones, hurricanes and floods will continue to wreak havoc (and increasingly so based on the pervasive view of global climate change scientists). These environmental impacts of economic development will negatively affect the global economy, including infrastructure and labour (this negative feedback loop was considered in The Stern Report 2006 and more recently during the Copenhagen and Paris global climate summits).

The overriding economic concern post 2008 was the Global Financial Crisis and its impact on countries at different stages of economic development. *Incidentally, Australia is one of the few countries in the world to use the term Global Financial Crisis (most countries call the prolonged economic downturn 'The Great Recession'.)*. From 2009-2012, the economic health of Cyprus, Greece, Portugal, Ireland, Italy and Spain was intensely questioned both from within those countries and by international organisations including the International Monetary Fund (they have facilitated rescue packages for some of these nations in coordination with the European Union and the European Central Bank). The crisis shifted from being 'just' one of private sector debt (particularly banks in US and Europe) to a full-blown sovereign (i.e. government) debt crisis (with real debt to GDP ratios well over 100%). Austerity programs (i.e. cutting expenses and increasing taxes to reduce government debt) were put in place by Governments in Europe and USA. At the same time unemployment levels stayed stubbornly high (e.g. Spain and Greece recorded unemployment rates of around 27% in mid-2013). Is austerity the correct policy response? (Nobel Prize winner Paul Krugman argues vehemently against these approaches). Deflation has been a major concern for these nations (along with Japan). Whilst the sovereign debt crisis has subsided, there are rising concerns about the financial health of Italy and a number of Central American economies (e.g. Venezuela).

In general terms, in fast forwarding to 2018, as mentioned in the earlier reports, global economic conditions are the most promising for a decade, with GWP excepted to grow between 3.5 to 4.0%. Indeed, the largest economy in the world, the USA, has a very low unemployment rate of 3.9% (below full employment) and the Federal Reserve has increased their official cash rate from 0% to 1.75-2.0%, with more rises to come. The global deflation concerns are beginning to wane, as advanced economies reduce their spare capacity, and these pre-emptive measures are attempting to ward of future inflationary expectations. That being said, the looming trade war, and private and public levels of global debt, present real risks to the future global economic outlook.

INTERNATIONAL ECONOMIC CONDITIONS

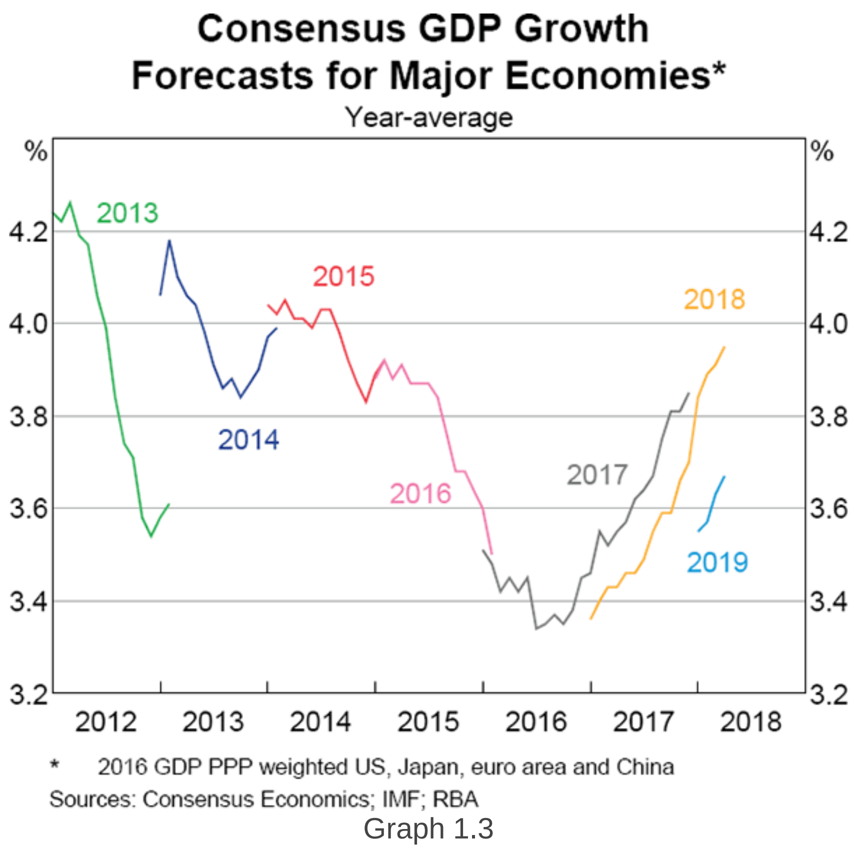
Statement on Monetary Policy – May 2018

International Economic Conditions

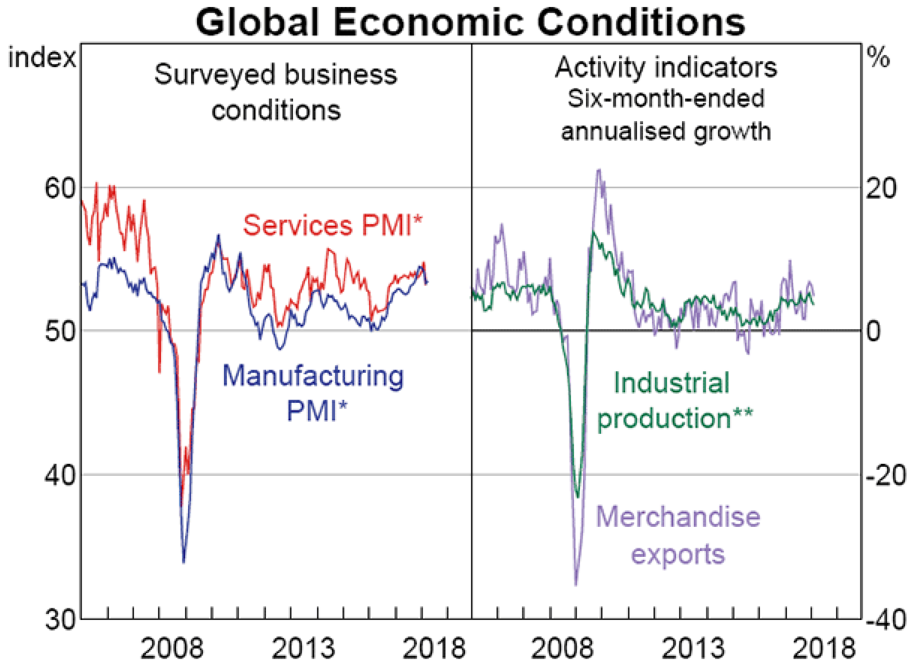
Global economic conditions were relatively strong in early 2018 and the drivers of growth have become more-broad based. The higher rates of growth for the major trading partners are expected to continue over the next couple of years; growth in the major advanced economies is expected to continue to exceed estimates of potential over this period. While global inflation remains low at present, these stronger economic conditions should see a further reduction in spare capacity and a gradual upward trend in inflation. In response, several advanced economy central banks are in the process of gradually reducing very accommodative monetary policies. More broadly, financial conditions have tightened modestly in recent months, most notably in US dollar money markets. Nonetheless, financial conditions remain accommodative and continue to support global economic growth. In the United States, growth will also be boosted by a substantial fiscal stimulus.

Global growth has strengthened and the outlook is more positive

Global economic conditions have improved over the past two years and growth forecasts for the major economies have been revised higher. Growth has also shifted from being driven primarily by consumption to being more broadly based. In particular, business investment has recovered, especially in some of the major advanced economies, and stronger global demand has supported growth in trade. While some activity indicators have eased a bit recently, they remain around multi-year highs.



Graph 1.3

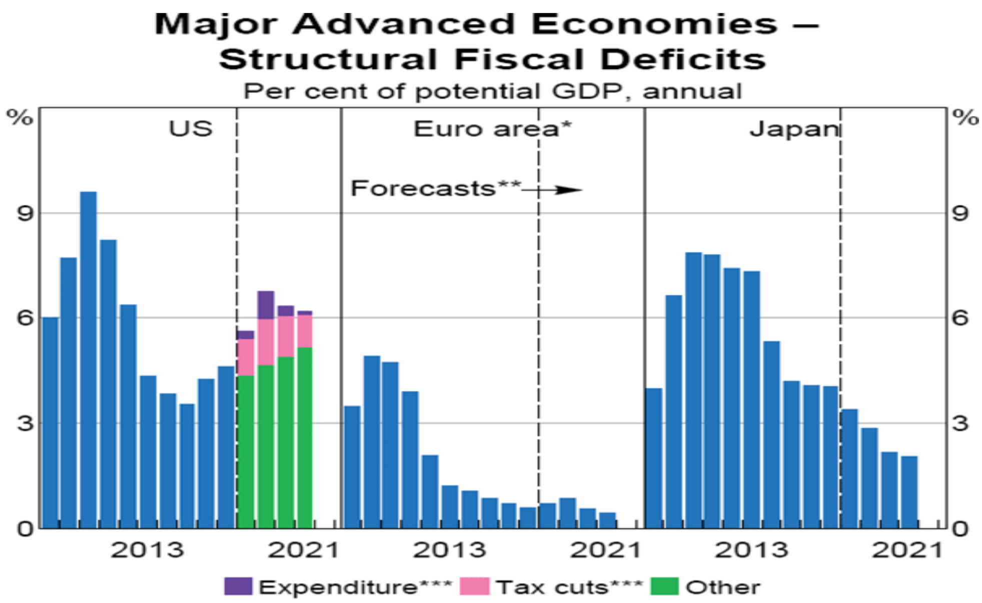


* Purchasing Managers' Index

** Weighted by world industrial production shares at market exchange rates

Sources: CEIC Data; CPB; IMF; Markit Economics; RBA; Thomson Reuters; United Nations

In the major advanced economies, monetary policies remain accommodative, although some of this stimulus is likely to be withdrawn in some economies. In the United States, tax cuts and increased government spending are expected to significantly boost private and public expenditure over the next couple of years. In Japan, the scheduled consumption tax increase will tighten fiscal policy noticeably in 2019.



* RBA estimate from 2020

** IMF forecasts from April 2018 WEO

*** CBO estimate of increase in deficit from the Tax Cuts and Jobs Act (2017) and Bipartisan Budget Act (2018); fiscal year estimates

Sources: CBO; IMF; RBA; Thomson Reuters

Growth in China is likely to moderate slightly in line with the recently announced growth target for 2018; the Chinese authorities have also signalled some tolerance for a gradual slowing in growth in order to give more weight to other policy objectives, such as reducing pollution and managing financial stability risks.

In east Asia (excluding China and Japan), recent indicators suggest that the slowing in growth at the end of 2017 was temporary; indicators of business conditions remain elevated, new export orders point to export growth remaining relatively high at least in the short term, consumer confidence is high and retail sales growth has strengthened. Growth is therefore expected to be around trend for the next couple of years. In India, the authorities' efforts to address high levels of non-performing loans in the banking system, including the revised recapitalisation plan for state-owned banks over the next two years, are expected to provide support to private investment by increasing credit supply. However, high corporate indebtedness and excess capacity in parts of the industrial sector may start to weigh on credit demand.

A number of uncertainties surround the outlook for the global economy. There is a risk that an escalation in protectionist measures or geopolitical events could harm global growth. In China, the pace of growth in financing has declined, but debt levels remain high and continue to pose downside risks to growth over the medium term. It is also possible that further strong growth in the major advanced economies could lead to a larger increase in inflation than expected, and result in a sharp tightening in global financial conditions.

WHAT IS GLOBALISATION?

N.B. Amended syllabus (2011) is focused on the influence and effects of globalisation (rather than just the impact).

Definition:

Globalisation is the process of breaking down of barriers to promote the internationalisation of goods, services, finance and resource markets throughout the world.

The **actual movement** across nations and the **capacity to move and the potential movement** across nations of:

- Trade
- Investment
- Technology
- Finance
- Labour

Types of Economies

In the amended syllabus, you must know the economic development process and key characteristics of THREE (3) main types of economies (learn main characteristics of each):

- Developing economies.
- Emerging economies.
- Advanced economies.

1. THE STATE OF GLOBAL TRADE IN GOODS AND SERVICES

The growth in global trade is generally more than double the level of GWP. Despite a slowdown after 1997 due to the Asian economic crisis, world trade grew by 12.4% in the year 2000 but slowed after the Sept 11 terrorist attacks and the US share market crash. The volume of world trade slowed to 6.8% in 2007. International trade is a critical channel for global integration. Despite a further drop in global trade in 2009, goods equivalent to 48% of GWP were traded in 2010, up from 32% in 1990 (showing how important trade has become as a part of the global economy). More recent growth prospects are summarised below:

MAIN POINTS: Growth Prospects 2018 and 2019 - WTO

- World merchandise trade volume is expected to grow 4.4% in 2018, accompanied by GDP growth of 3.2% at market exchange rates.

- Faster trade expansion is being driven by stronger economic growth across regions, led by increased investment and fiscal expansion.

- Trade growth in 2018 is likely to fall within a range from 3.1% to 5.5% if current GDP forecasts come to pass, although a continued escalation of trade restrictive policies could lead to a significantly lower figure.

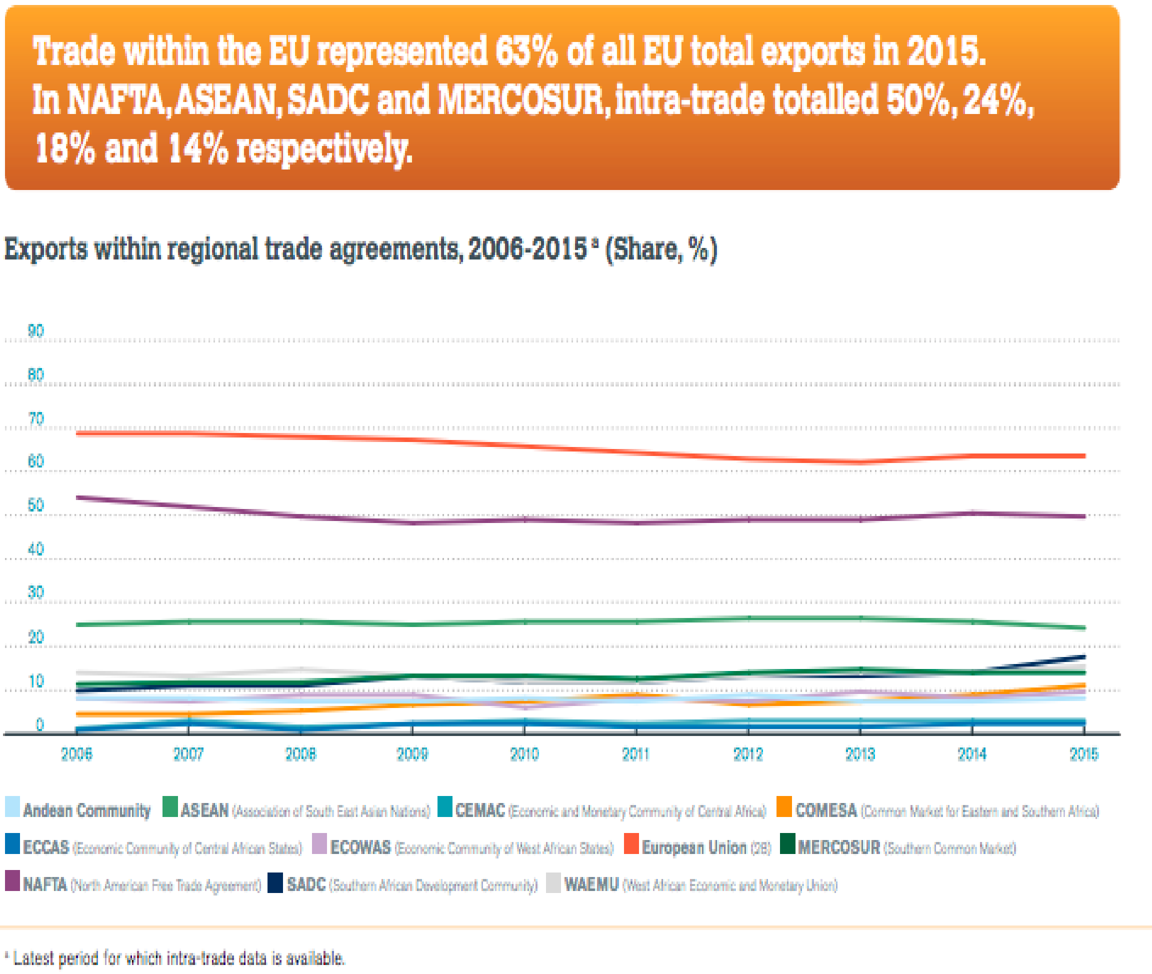
- Trade growth should moderate to 4.0% in 2019 even as global GDP growth slows slightly to 3.1%.

- The ratio of trade growth to GDP growth should remain at 1.4 in 2018, down slightly from 1.5 in 2017.

- Risks are centred on trade and monetary policy, where missteps could undermine economic growth and confidence.

- An index of export orders has recently weakened, possibly signalling an effect of greater uncertainty brought about by heightened trade tensions.

Intra-regional trade, within trade blocs, still dominates global trade



2. FINANCIAL FLOWS

International financial flows have grown most rapidly of all, at 10 times the rate of GWP. Since the phasing out of controls on foreign exchange trading in the 1970's, international financial flows have grown exponentially. In 1980, global foreign exchange trading was 10 times the value of world trade. Foreign exchange trading is now estimated to be more than 100 times the value of world trade and growing (approximately $5-7 US trillion turnover per day, although this figure declined significantly in 2008 and 2009, before recovering again over the past half a decade). The level and direction of international financial flows are now the main determinants of the value of most nations' exchange rates. Trade in goods and services have little direct impact on the exchange rate today, except perhaps as a psychological influence on the behaviour of international financial traders. Despite this, the volume and value of trade in goods and services is a fundamental economic indicator of the health of the domestic and global economy. Hence, it does influence (particularly over the long-term) global financial markets (including the FOREX market).

Financial flows take many forms. The fastest growing area has involved interest rate, credit, currency, equity, and commodity derivatives. Interest rate, credit and currency derivatives make up over 90% of the total value of derivatives traded. The turnover in the derivatives markets is now much larger than the cash markets. Only 1% of the foreign exchange market involves payments for trade. Most of it involves forms of derivatives trading.

NOTE:

For the purpose of the syllabus, financial flows are generally referring to Foreign Portfolio Investment (i.e. investment in debt and equity securities of a short-term nature), plus the aforementioned derivatives and currency trading. Whereas, Investment and TNCs (below) is primarily focused on Foreign Direct Investment.

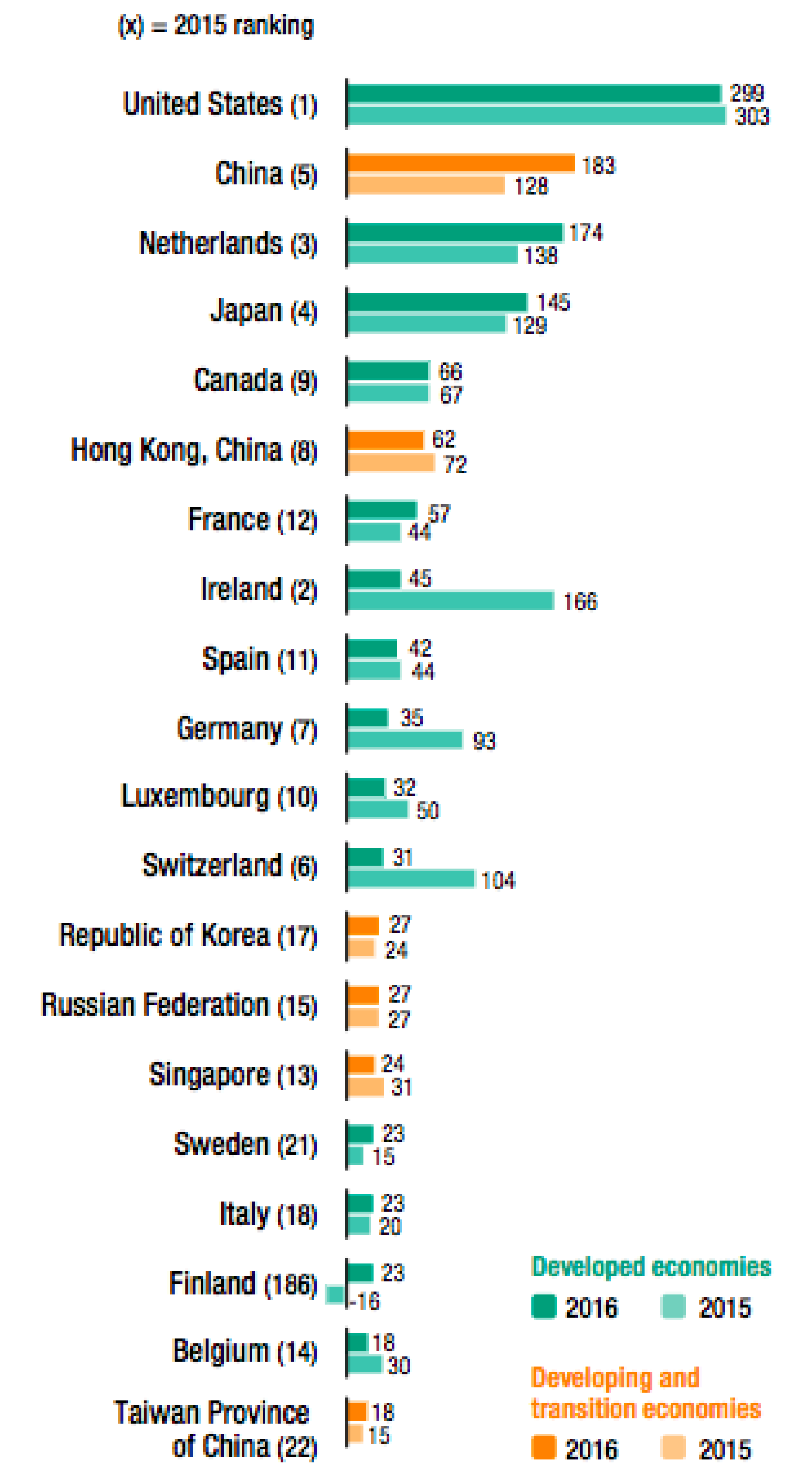
3. INVESTMENT AND TNCS (FOREIGN DIRECT INVESTMENT)

This relates to investment by Transnational Corporations (TNC's). This is also known as International Direct Investment (IDI) or Foreign Direct Investment (FDI).

INVESTMENT PROSPECTS – World Investment Report 2017

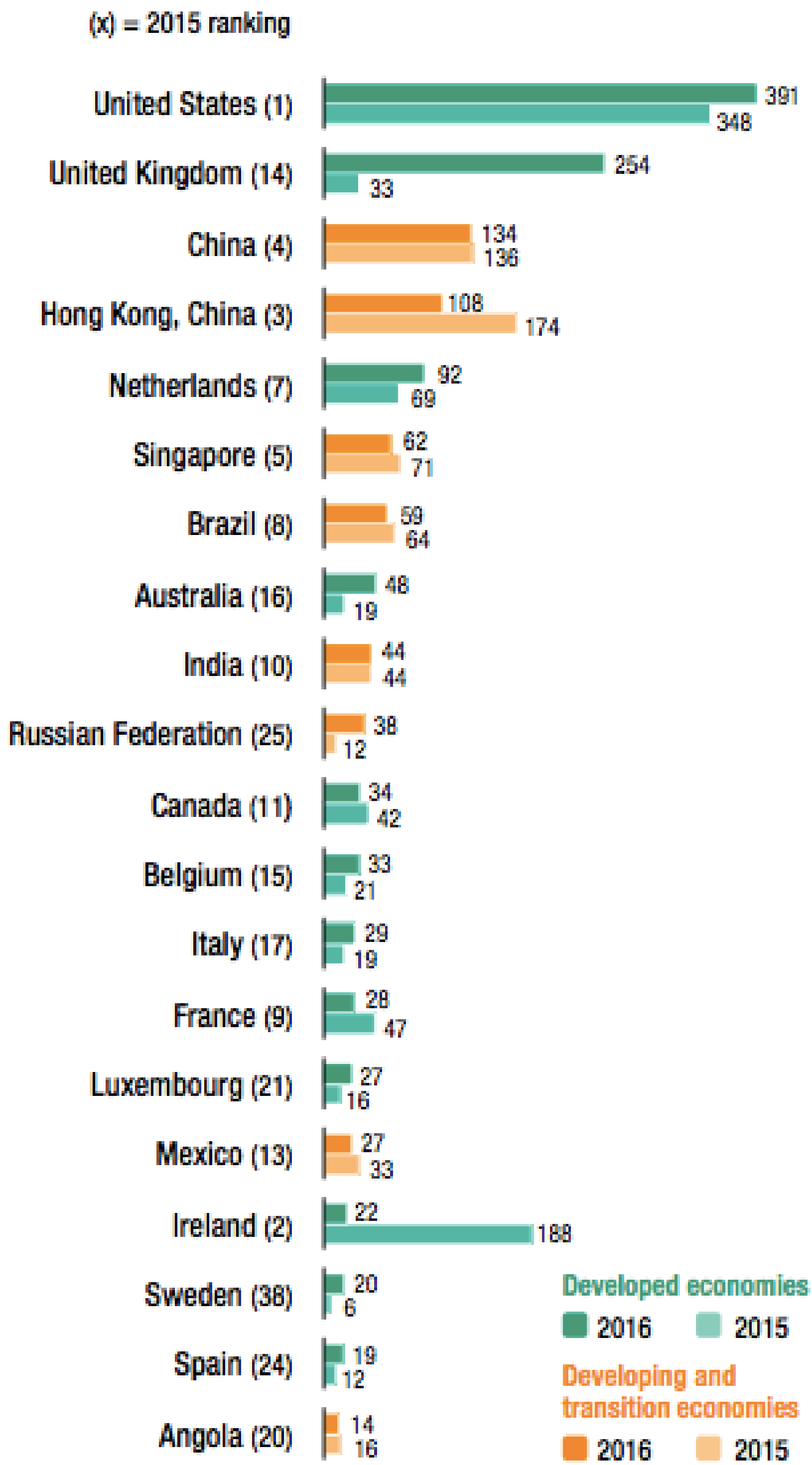
Global investment is seeing a modest recovery, with projections for 2018 cautiously optimistic. Higher economic growth expectations across major regions, a resumption of growth in trade and a recovery in corporate profits could support a small increase in foreign direct investment (FDI). Global flows were forecast to increase to almost $1.8 trillion in 2017, continuing to $1.85 trillion in 2018 – still below the 2007 peak. Policy uncertainty and geopolitical risks could hamper the recovery, and tax policy changes could significantly affect cross-border investment. FDI prospects are moderately positive in most regions, except Latin America and the Caribbean. Developing economies as a group are expected to gain about 10 per cent. This includes a sizeable increase in developing Asia, where an improved outlook in major economies is likely to boost investor confidence. FDI to Africa is also expected to increase, with a modest projected rise in oil prices and advances in regional integration. In contrast, prospects for FDI in Latin America and the Caribbean are muted, with an uncertain macroeconomic and policy outlook. Flows to transition economies are likely to recover further after their economies bottomed out in 2016. Flows to developed economies are expected to hold steady in 2017.

Figure I.14. **FDI outflows, top 20 home economies, 2015 and 2016** (Billions of dollars)



Source: ©UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

Figure I.11. FDI inflows, top 20 host economies, 2015 and 2016 (Billions of dollars)



Source: ©UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

Investment Trends – World Investment Report 2017

After a strong rise in 2015, global FDI flows lost growth momentum in 2016, showing that the road to recovery remains bumpy. FDI inflows decreased by 2 per cent to $1.75 trillion, amid weak economic growth and significant policy risks, as perceived by multinational enterprises (MNEs). Flows to developing economies were especially hard hit, with a decline of 14 per cent to $646 billion. FDI remains the largest and most constant external source of finance for developing economies – compared with portfolio investments, remittances and official development assistance.

But inflows were down across all developing regions:

- FDI flows to developing Asia contracted by 15 per cent to $443 billion in 2016. This first decline in five years was relatively widespread, with double-digit drops in most sub regions except South Asia.

- FDI flows to Africa continued to slide, reaching $59 billion, down 3 per cent from 2015, mostly reflecting low commodity prices.

- The downward trend in FDI flows to Latin America and the Caribbean accelerated, with inflows falling 14 per cent to $142 billion, owing to continued economic recession, weak commodity prices and pressures on exports.

- FDI in structurally weak and vulnerable economies remained fragile. Flows to the least developed countries fell by 13 per cent, to $38 billion. Similarly, those to small island developing States declined by 6 per cent, to $3.5 billion. Landlocked developing countries saw stable FDI, at $24 billion. Flows to developed economies increased further, after significant growth in the previous year. Inflows rose by 5 per cent to $1 trillion. A fall in FDI in Europe was more than compensated by modest growth in North America and a sizeable increase in other developed economies. Developed economies' share in global FDI inflows grew to 59 per cent.

Major economic groups, such as the G20 and APEC, strongly influenced global FDI trends. Inflows to the G20 reached a record of more than $1 trillion for the first time. Intragroup FDI is a growing feature in some groups.

4. TECHNOLOGY, TRANSPORT AND COMMUNICATION

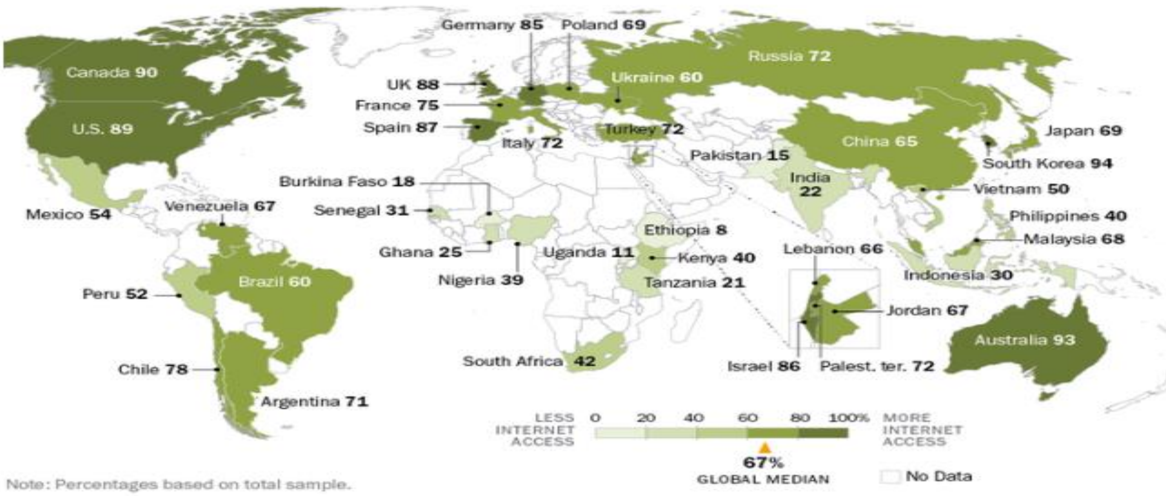
New information and communication technologies are driving globalisation. The cost of global communication is declining and innovative tools are becoming easier to use. The Internet, mobile phones and electronic funds transfer are opening up the global market place. The internet had more than 4.1 billion (54% of the world's population) users in 2017 compared to 140 million users in the middle of 1998 (3% of the world's population). In the last decade, there has been a surge in uptake, particularly from developing and emerging citizens in Africa, Asia and the Middle East. Improved communication can foster great advances in health care and education. It also breaks down barriers of size, time, and distance. Costs are falling for small businesses, as they move from a domestic market place to a global one.

Pew Research Centre - key findings on Global ICT uptake:

- Smartphone ownership rates have skyrocketed in many countries since 2013. This includes increases of over 25 percentage points among the total population in large emerging economies such as Turkey (+42 points), Malaysia (+34), Chile (+26) and Brazil (+26).
- South Korea stands out as the country with the highest smartphone ownership rate, with 88% of respondents saying they own one. The countries with the least smartphone ownership rates are also among the poorest: Tanzania (11%), Uganda (4%) and Ethiopia (4%).
- In a number of emerging and developing countries, more people have access to the internet and are also using it more frequently. In 12 emerging nations surveyed in 2014 and 2015, there were significant increases in the share of adult internet users who say they access the internet several times a day, including in Nigeria (+20 points), Ghana (+19) and China (+13).
- There are gender gaps on many aspects of technology use. For example, in 20 nations, men are more likely than women to use the internet. These differences are especially stark in African nations. Elsewhere, equal shares of men and women use the internet. But large gender gaps also appear on reported smartphone ownership (men are more likely to own a smartphone) in many countries, including Mexico (+16), Nigeria (+13), Kenya (+12) and Ghana (+12).

Two-thirds worldwide use the internet, but fewer do in Africa and South Asia

Percent of adults who use the internet at least occasionally or report owning a smartphone



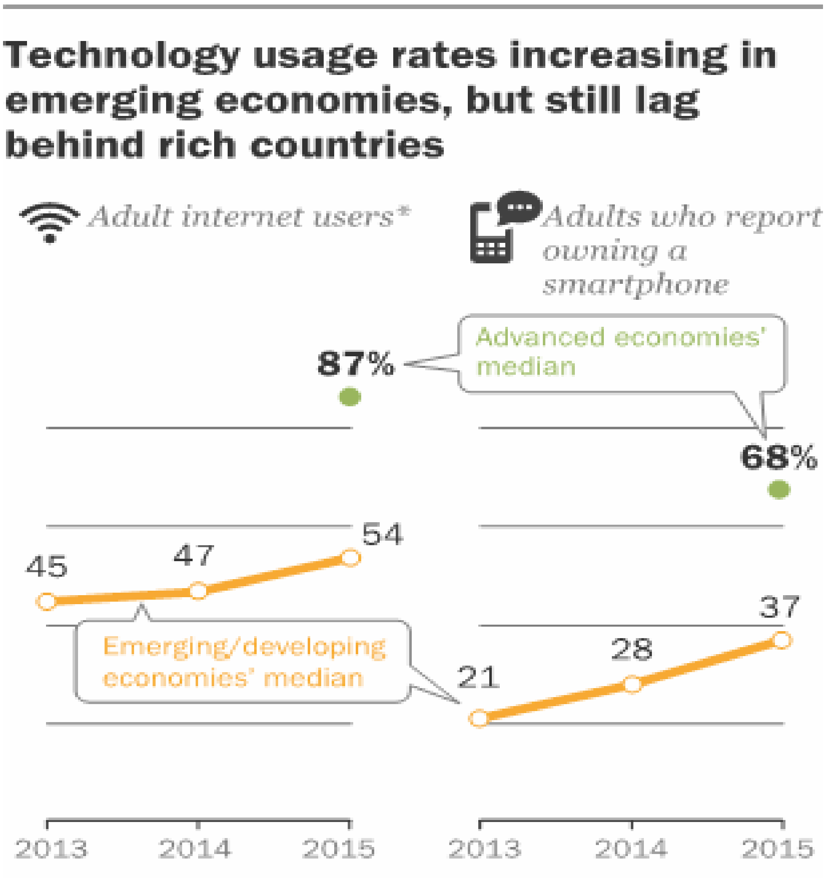
Note: Percentages based on total sample.

Source: Spring 2015 Global Attitudes survey. Q70 & Q72.

PEW RESEARCH CENTER

Mobile Phone Usage

Information and communications technology has vast potential for fostering growth in developing countries by helping to increase productivity in a wide range of economic activities from agriculture to manufacturing and services. Mobile phones keep families and communities in contact and provide market information for farmers and business people. According to the International Telecommunication Union, mobile phone number of mobile phone users in the world is expected to pass the five billion mark by 2019. In 2016, an estimated 62.9 percent of the population worldwide already owned a mobile phone. The mobile phone penetration is forecasted to continue to grow, rounding up to 67 percent by 2019. China was predicted to have just over 1.4 billion mobile connections in 2017, while India was forecast to reach over one billion. By 2019, China is expected to reach almost 1.5 billion mobile connections and India almost 1.1 billion. The statistic shows the total number of mobile phone users worldwide from 2015 to 2020. In 2019, the number of mobile phone users is forecast to reach 4.68 billion.



Transports: Containerisation – Really that big a deal?

For many years, it was thought to be impossible to quantify the value of containerisation, because the advent of the metal box coincided with a global reduction in trade barriers as a result of European integration and the work of the General Agreement on Tariffs and Trade (GATT), the predecessor of the World Trade Organisation (WTO). But a paper published in February 2013 cleverly disentangles the impact of trade deals from that of containers. Looking at 22 industrialised countries, it finds that containerisation is associated with a 320% increase in bilateral trade over the first five years and 790% over 20 years. A bilateral free-trade agreement, by contrast, boosts trade by 45% over 20 years, and membership of GATT raises it by 285%. In other words, containers have boosted globalisation more than all trade agreements in the past 50 years put together. Not bad for a simple box.

Source: Economist - May 22nd 2013

The Improvements in technology also bring up the issue of intellectual property rights. Tighter property rights are increasing the price of technology transfer, blocking many developing countries from their use, whether it is in production, communication, education or health care. This in turn increases the power and wealth of those who largely own the property rights, the transnational corporations.

5. THE INTERNATIONAL DIVISION OF LABOUR, MIGRATION

- It is true that there has been some contraction in employment in labour intensive industries such as textiles and footwear in advanced economies over the past 30 years as production has moved to countries in which labour is cheaper. However, this is part of the process of development. It would be condemning less developed countries to even greater poverty to ban or restrict their ability to compete in industries like textiles in rich markets.

- Wage levels differ between countries according to the levels of education and productivity. The experience in countries like Korea is that as countries develop, their wage levels rise and the focus of their industry shifts from labour intensive to more capital and knowledge intensive industries.

- The movement of labour between economies appears to be concentrated at the top and bottom ends of the market. Highly skilled workers are being attracted to the richest economies such as the US and in Europe hence the identification of a “brain drain” affecting Australia and many developing and emerging nations (the remittance of funds back to the ‘home’ country is considered one significant benefit).

- Similarly a trend for low skilled workers from the less developed world to fill the bottom end of the labour market is developing in Europe and the US.

- There still remain significant barriers to the globalisation of labour as a result of immigration restrictions, language, cultural and educational barriers. This has resulted in a shift of business to where cheaper labour exists.

Employees in advanced economies (in manufacturing related industries) are facing insecurity and are less likely to press for higher wages knowing that production processes are being transferred (i.e. outsourced). Importantly, and in contrast to this point, some US manufacturing companies are insourcing production (i.e. moving previously outsourced production back to the US as wages in real terms have dropped and to enhance the quality of their products). Will this continue?

The international movement of labour has been growing since the 1960’s. The movement of people across national borders is a visible and increasingly important aspect of global integration. 3% of the world’s population – more than 213 million people – now live in countries in which they were not born. The forces driving the flow of migrants from poor countries (or advanced countries suffering prolonged recessions) to rich economies are likely to grow stronger in the future.

Migration is often accompanied by a flow of remittances – transfers of gifts and wages and salaries earned abroad – from migrants to their countries of origin. The direction of the remittances is related to the geographical movement of the labour force and the relative economic positions of sending and receiving countries, as well as the impact these flows have on the receiving economies (this cannot be underestimated). Over the past decade, international migration has intensified and this is reflected in remittances becoming and increasing source of financial flows to low and middle-income countries.

There are now an estimated 258 million people living in a country other than their country of birth — an increase of 49% since 2000 — according to new figures released by UN DESA today, on International Migrants Day. The International Migration Report 2017 (Highlights), a biennial publication of the department, states that 3.4% of the world's inhabitants today are international migrants. This reflects a modest increase from a value of 2.8% in 2000. By contrast, the number of migrants as a fraction of the population residing in high-income countries rose from 9.6% in 2000 to 14% in 2017.

THE CAPACITY TO MOVE AND THE POTENTIAL MOVEMENT ACROSS NATIONS

The second component of globalisation involves the potential impact of changes in the global market on economies. It means businesses consider the potential entry of international competitors into their markets. Businesses plan pricing strategies and employment policies based on what could happen if cheap foreign producers or TNC's entered the market. It also means businesses consider, or threaten to set up, their operations in countries where profits are expected to be greatest, Eg. Low wage countries, where unions are suppressed and there are low corporate tax rates. Governments and employers use these fears to push for labour market and workplace reforms. Governments reduce business taxes to ensure tax competitiveness to attract transnational corporations and international finance, while the average tax of workers rises to balance the budget.

The globalised financial market, and the ease with which funds can be transferred, means that finance is allocated according to international criteria of expected profitability and risk. Governments, businesses, wealthy individuals, and financial organisation make decisions based on pleasing international financial markets and gaining greatest income and wealth. This often generates asset inflation and speculative bubbles that go through periods of boom and bust, without necessarily adding to the productive capacity of a nation.

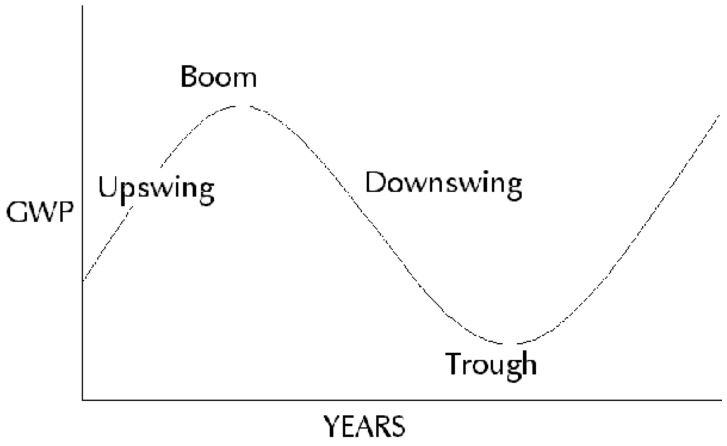
Globalisation has the potential to benefit all of humanity or create income and employment insecurity, destroy traditional values and cultures, create environmental degradation, increase crime, decrease health standards and increase the gap between the haves and the have nots. The willingness and ability of governments to deal with the spread and impact of globalisation could well determine the eventual outcome.

THE INTERNATIONAL AND REGIONAL BUSINESS CYCLES

The major phases of the Regional and International Business Cycles are identical to those of Domestic Business Cycles. Typically, the four phases include:

- Expansion or upswing.
- Boom or peak.
- Downswing or recession.
- Trough.

Gross World Product (GWP) is the total production of goods and services from all economies in a given time frame.



THE RESURGENT GLOBAL ECONOMY – HOW LONG WILL IT LAST?

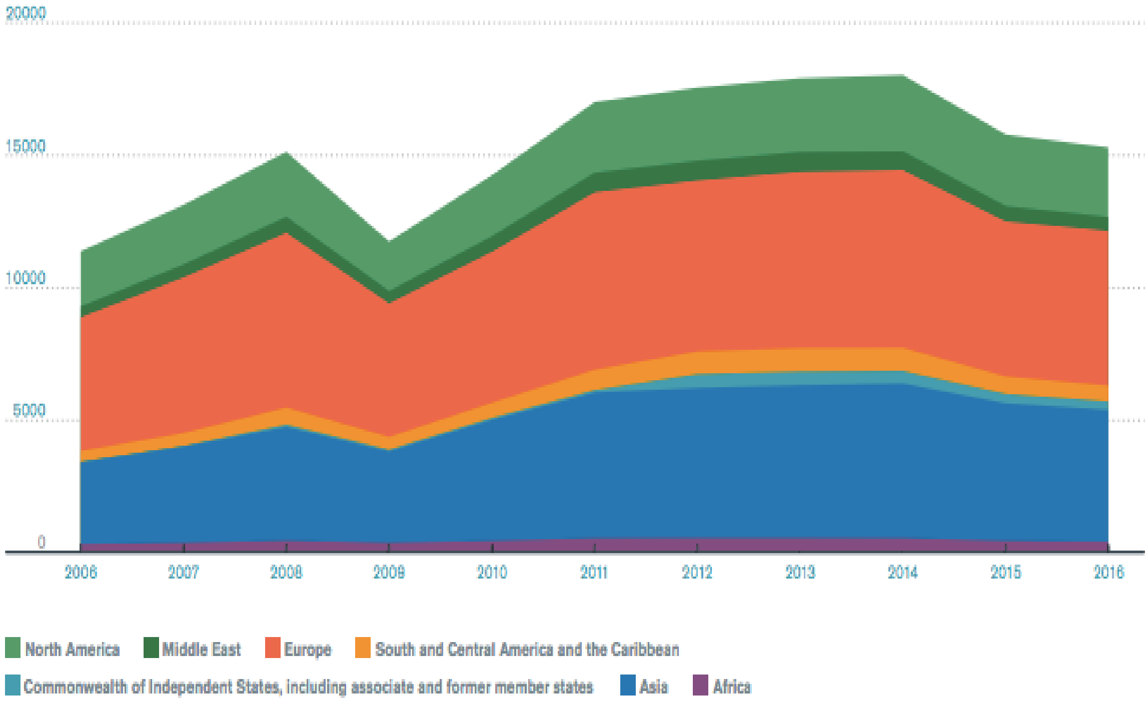
TRADE, FINANCIAL FLOWS AND FOREIGN INVESTMENT

The data below depicts the global flows of trade. Trade Liberalisation and the emergence of strong multilateral trading blocs and agreements have seen the volume and value of goods and services traded across nations increase.

Most developing nations remain heavily dependent on exporting primary products. There has been a significant growth in the trade of Elaborately Transformed Manufactures (ETMs).

Merchandise trade of WTO members has increased to US$ 15.4 trillion, up from US$ 11.7 trillion in 2006.

World merchandise trade of WTO members, 2006-2016 (US$ billion)



Source: www.WTO.org

FREE TRADE AND PROTECTION

THE BASIS OF FREE TRADE – ITS ADVANTAGES AND DISADVANTAGES

This refers to the removal of artificial barriers to trade. The WTO has campaigned strongly for continued trade liberalism and the removal of protection. Adam Smith in the Wealth of Nations focused on the principles of Absolute advantage whilst Ricardo discussed the efficiencies which derive from Comparative Advantage.

Advantages of Free Trade include:

- Ability of countries to specialise on those goods and services in which they have a comparative advantage (leading to division of labour and increased productivity).
- A more efficient allocation of resources will ensue (medium to long-term).
- Economics of scale will result leading to lower cost structures and decreased prices.
- Increased choice and lower prices for households and firms.
- Decreased imported inflation (with increased imports of consumer and capital goods).
- Increased international competitiveness of exporting and import-competing firms.
- Capital deepening and technological advancement.

Disadvantages of Free Trade include:

- Short-term structural unemployment (e.g. TCF and PMV industries in Australia).
- Rent seeking behaviour from firms facing increased competition.
- Increases in imports and worsening of trade balance (in short-medium term).
- Loss of production in trade liberalising industries, including ‘infant’ industries.
- Dumping of surplus international stock on domestic markets.

The global movement towards free trade increased pace from the 1980s-2000s, with some concern that countries would increase protectionist measures during and after GFC. This, to a large extent, has been averted. Despite this, there are considerable impediments to the removal of all artificial barriers.

REASONS FOR PROTECTION

Despite the obvious benefits to be gained through specialisation and free trade, countries have long continued to impose barriers to free trade in a variety of different forms:

- The prevention of dumping.
- Protection of Infant Industries.
- Protection of domestic employment.
- Diversification and Self Sufficiency.
- National Defence.
- Maintaining National Identity.

There is valid argument for protecting against the practice of dumping and the WTO allows countries to protect domestic industries when a case of dumping is discovered. The infant industry argument is said to be valid as a short term form of protection but becomes less valid the longer it takes for domestic industries to achieve efficiencies which allow them to compete on a level playing field. The protection of domestic employment is often put forward as a strong argument to justify trade barriers but a number of points can be made which identify flaws in this argument.

METHODS OF PROTECTION

Countries are able to use a variety of methods in protecting domestic industries against foreign competition. The impacts of these protective measures vary to some extent but the essential objective of any method of protection is to favour local industry against the pressure of foreign competition, which allows domestic firms a greater share of the market than would have been possible without assistance.

The common forms of protection include such measures as:

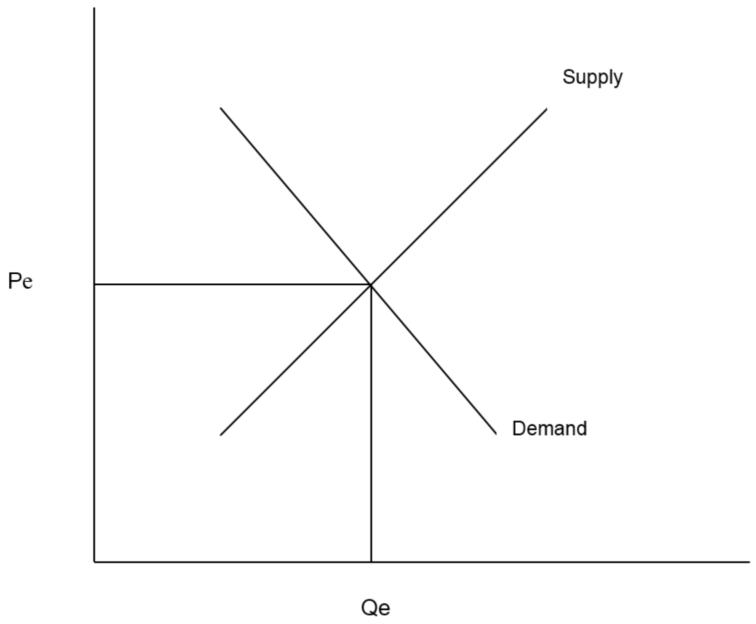
- Tariffs
- Subsidies
- Quotas
- Local content rules
- Export incentives
- Import regulations
- Quarantine regulations (including embargoes/bans on specific types of goods)

The syllabus requires pupils to be able to analyse these measures of protection with particular attention to tariffs, subsidies and quotas.

Tariffs are taxes imposed on firms importing foreign produced goods into the domestic market. For the purpose of analysis, assuming the tariff is set at a per unit value, let us consider how the dynamics of the market change with the use of a tariff to protect a domestic industry.

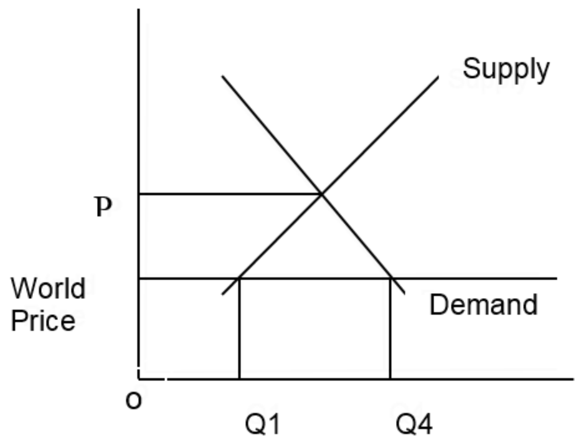
Prior to any foreign competition, market equilibrium is the result of the interaction of domestic demand and supply conditions as demonstrated in Graph 1.

Domestic market Conditions (Graph 1)



With the entry of foreign competition, which charge a lower price than the current domestic price, local firms are forced to lower their price to maintain some level of market share as demonstrated in Graph 2.

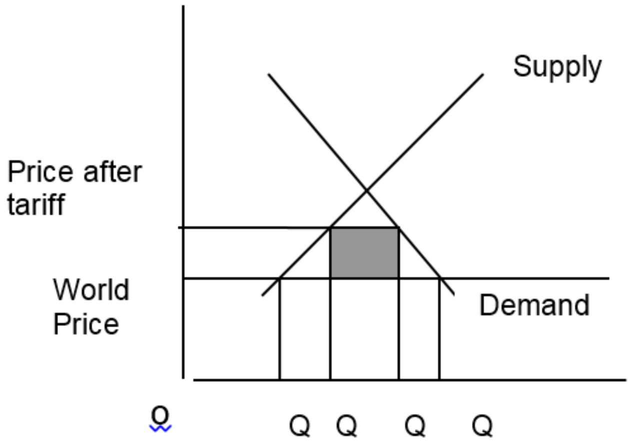
Introduction of foreign competition (Graph 2)



The market share of domestic firms has been reduced to 0Q1 and the share of the local market going to foreign firms is Q1Q4.

Should the government decide to offer the local industry tariff protection then the market conditions will change as demonstrated in Graph 3.

Imposition of a tariff (Graph 3)



The market share going to local firms (after tariff) has increased to 0Q2 and the share going to foreign firms has shrunk to Q2Q3. The shaded rectangular area under the original equilibrium represents the level of revenue the government receives as a result of the tariff.

IMPACTS OF THE TARIFF

Price Effect: The increase in market price as a result of the imposition of the tariff on foreign competition. If tariff protection is widespread then there is a likely to be a higher cost of living across the economy.

Reallocation Effect: The increase in resources now allocated to a relatively less efficient local industry. These resources might have been available to other more efficient sectors within the domestic economy. This is why protection is said to create a distortion in the allocation of resources.

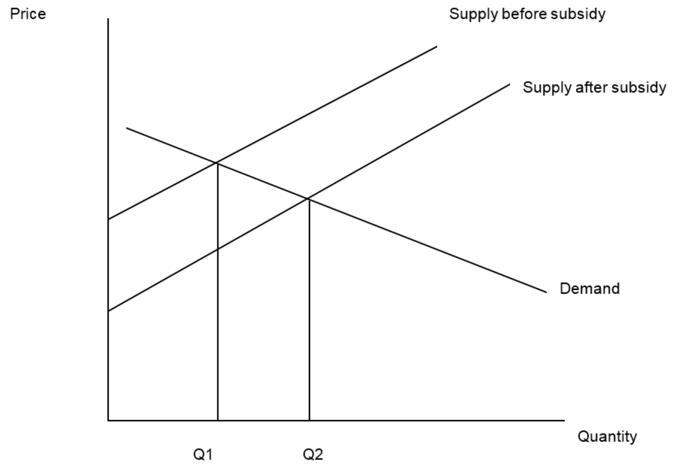
Redistribution Effect: The transfer of income away from domestic consumers in the form of higher prices to local producers and reduced profits of foreign firms lifting the profits of local producers.

Revenue Effect: The tax collected from consumers in the form of higher prices which flows to the government.

Retaliation Effect: The possible retaliation, by way of trade barriers from foreign governments, on the exports of the local economy thereby reducing export profitability.

SUBSIDIES

Subsidies are any form of financial assistance given to local producers allowing them to lower their costs of production and compete more effectively with foreign competition. The use of a subsidy is demonstrated in the graph below, where domestic supply has been increased allowing for a greater share of the market to be provided by local producers. The size of the subsidy is the vertical distance between the original supply curve and the supply curve after the subsidy.



Subsidies are an expenditure of the government to selected industries and as such draw revenue to that industry from government revenue. The opportunity cost of providing subsidies is measured in terms of what that same level of revenue could have been used for.

It is not uncommon for the methods of protection to be examined in the short answer section of the HSC examination. The questions asked will normally require some calculation of effects and comments regarding the impacts of the protection on the participants in the market.

QUOTAS

Quotas are a limitation on the quantity of a foreign product that can be brought into the domestic market. Quotas will generally force foreign importers to raise the price of the good to ensure profits from a smaller quantity and this allows domestic producers to supply the remainder of the market at the higher price level.

A quota differs in its impact from a tariff by not raising tax revenue, however there may be charges imposed on importers to obtain quotas which effectively provides some level of revenue to the government.

Protection may also be offered through a combination of tariff and quota, where imported goods within the quota pay a standard tariff rate but goods beyond the quota are charged a much higher rate.

LOCAL CONTENT RULES

Local Content Rules specify that a certain percentage of a good has to be produced by domestic industry.

TRADING BLOCS, MONETARY UNIONS AND FREE TRADE AGREEMENTS (ADVANTAGES AND DISADVANTAGES)

European Union (Trading Bloc, Customs Union and partial Monetary Union) – Plus BREXIT

The **EU** is the world's largest trading bloc. Formed under the Maastricht Treaty of 1993. The EU abolished tariffs within its boundaries and established a common external tariff and a Common Agricultural Policy encouraging heavy subsidisation of EU agriculture. Since 1999, the EU has moved slowly towards a full monetary union (including a common currency in many of the member nations and the development of a European Central Bank). The United Kingdom will exit the EU in 2019.

Other trading blocs or 'groupings' include:

- **NAFTA**: Between USA, Canada and Mexico. Created to improve the competitiveness of these nations with the EU and Japan.

- **APEC:** Asia Pacific Economic Cooperation: Aims to promote free trade amongst Pacific Rim Nations. Japan and USA are the major members. The Bogor declaration signed in 1994 set the agenda to remove trade barriers between the 21 member states by 2020. This organisation is very influential owing to the contribution of member states to world economic output and trade.

- **ASEANFTA:** The Association of South East Nations.

- **CERTA:** Closer Economic Trade Relations Agreement is a bilateral trade agreement between Australia and New Zealand.

- Other blocs or agreements include: **MERCOSUR** (South America) and the **African Free Trade Zone** (made up of 3 trade blocs).

- The **Comprehensive and Progressive Agreement for Trans-Pacific Partnership** (**TPP-11**) is a free trade agreement (FTA) between Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, Peru, New Zealand, Singapore and Vietnam. The deal was signed by the 11 countries on 8 March 2018 in Santiago, Chile.